RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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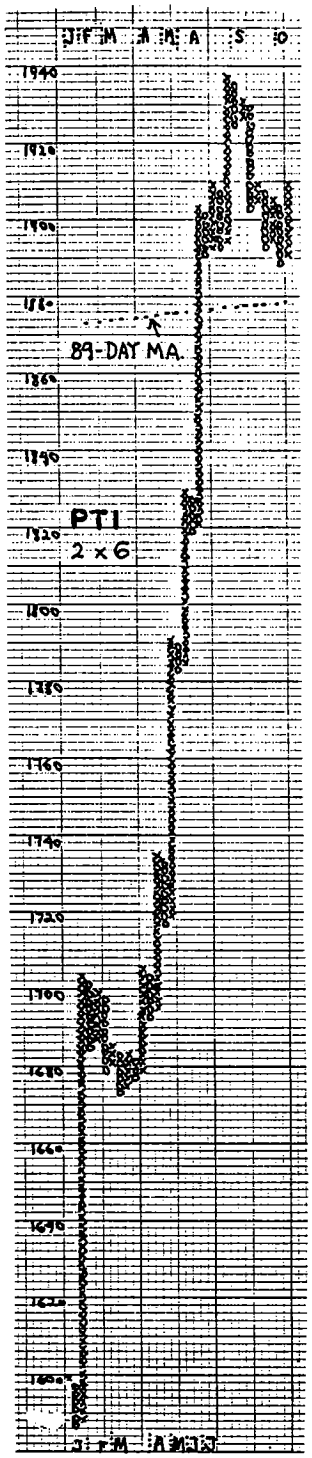
Oct. 11 DJIA 1339.94; PTI 1899; A-D Ratio -15.83
Oct. 18 DJIA 1368.84; PTI 1915; A-D Ratio -15.30

THE PICTURE: The underlying principle of my Primary Trend Index is HARMONY. During a primary bull market there exists technical harmony on the upside.



By that I mean that the majority of technical considerations such as price action, advances and declines, highs and lows, bond action, most-active stock action, all of these tend to move IN HARMONY on the upside.

The exact same phenomenon is true in reverse during a primary bear market. When a bear market is in progress, HARMONY exists on the downside. Over the course of any major bear leg, the great majority of the technical action is in harmony on the downside.

My Primary Trend Index (PTI) is constructed to measure technical harmony or the lack of it. Thus, during a strong bull movement the PTI will tend to push up day after day and week after week. It does so because during a strong bull movement the MAJORITY of technical indications show up as bullish in session after session. But at some point the bull forces will weaken, and it is here that divergence in the technical action occurs. Divergence leads to loss of upside momentum in the PTI. In time, this loss of momentum gives way to a top. And the next action is to the downside.

As the bearish forces begin to dominate, the technical harmony switches to down. Often, this whole picture takes the form of a head-and-shoulders top pattern in the PTI. Once the support under the head-and-shoulders pattern is cracked, a reaction or even a primary bear market may be underway.

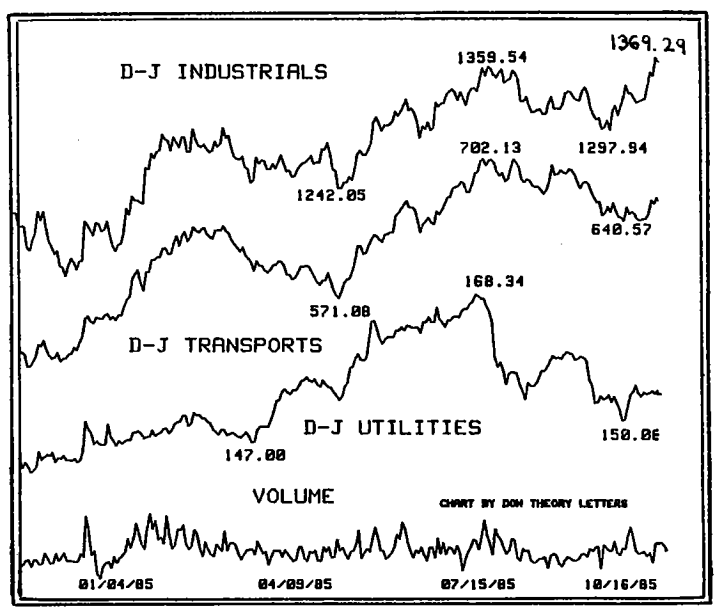
Let me put it more simply. When the PTI is rising on a major trendline basis (i.e., rising above a major rising trendline) the inference is that the market forces are bullishly advancing in harmony. When the PTI is declining below a major trendline, the inference is that the bearish forces are pushing the market down -- in harmony.

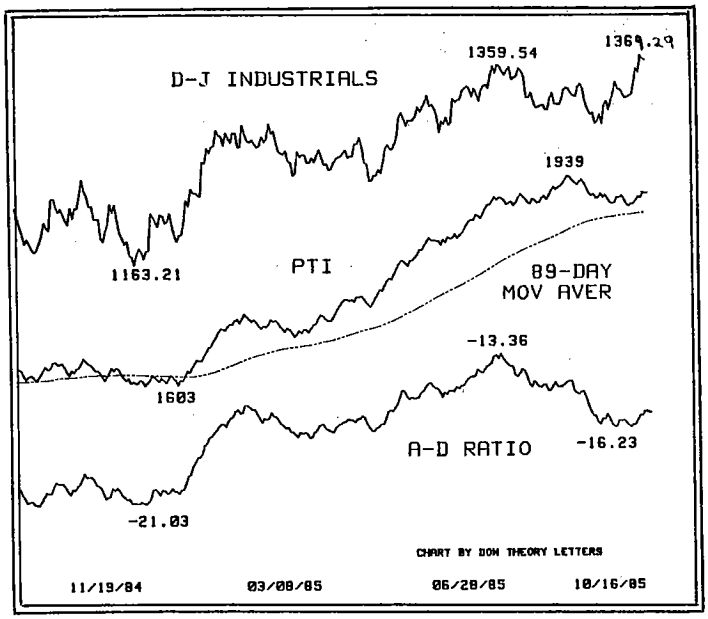
Question: Where are we now from the standpoint of the PTI and the Dow Theory?

Answer: I am including this point and figure chart of the PTI (page 1) covering all the action during 1985. As you can see, the PTI has advanced in what I term a huge stilt formation during 1985. During August and September, the PTI formed a head-and-shoulders top formation and on October 8, the PTI broke support when it slipped to 1890. A rally has followed as is often the case when important technical support is violated.

From the bearish standpoint, the situation is potentially dangerous because a head-and-shoulders top has appeared following the huge, uncorrected stilt formation. If the trend of the PTI turns decisively down in the period ahead, the PTI (and, of course, the market) could correct the entire 1984-85 rise (and the rise was 419 points in terms of the PTI).

From the plus side, the PTI has not yet broken below its 89-day moving average. As this is written, the 89-day MA is approximately 1880. All major declines in the PTI ultimately break below the 89-day MA. So far, this has not occurred.

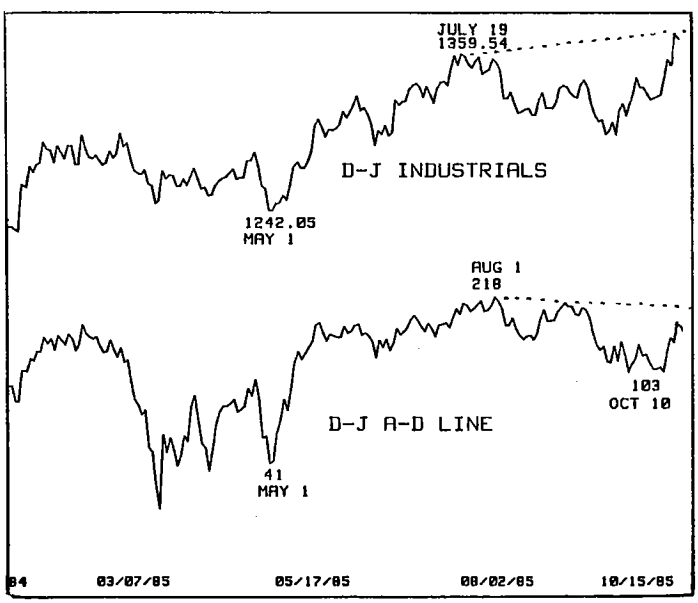




From a Dow Theory standpoint, nothing bearish has so far been proved. The July-October decline (see page 1 chart) took the Industrials and Transports down to 1297.94 and 640.57 respectively. On the rally back Industrials surged to a new record high of 1369.29 on October 17. Transports failed by a wide margin to confirm. What happens from here is important. If, in due time, the Transports confirm by rallying above their old high of 702.13 we will have an all-clear signal and the primary bull trend will resume. If, however, the two Averages turn down from here and the October lows of 1297.94 and 640.57 are broken, the Dow Theory will be signaling a primary bear market. Thus, it's not our job to reason why, it's our job to watch for the eventual "bloodless verdict of the market".

Question: So Russell, you're saying that your PTI has formed what could be a top -- but from the Dow Theory standpoint the market is still bullish. Is that correct?

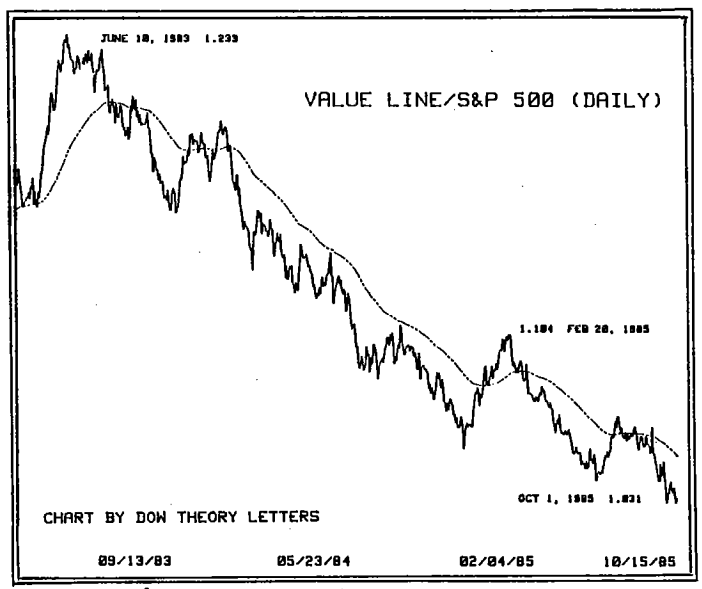
Answer: That is correct. In the current situation, my caution is based on the toppy action of the PTI. But in due time, the PTI and the Averages will tell us whether this market is in trouble or not.



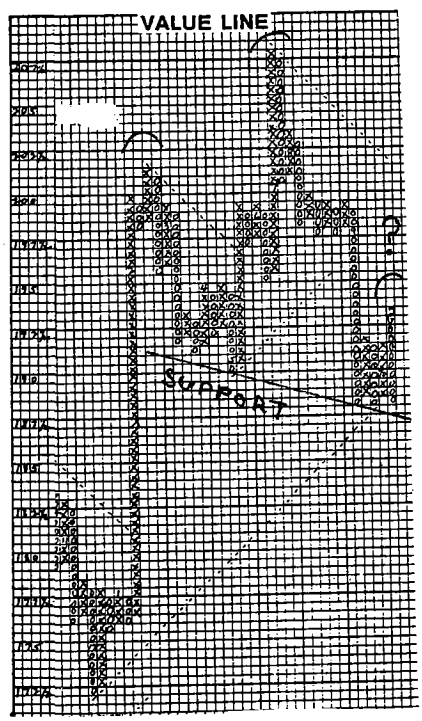
Question: Are there any other technical considerations that you feel are important at this time?

Answer: Yes, and I'll go over a few of them now. Unfortunately, most of my "other considerations" are not positive ones. First , I am including a chart of the Dow and its own A-D line (below left). The latter is simply a daily cumulative advance-decline line of the 30 Dow Industrial stocks. As you can see, the Dow A-D has lagged, and as of this writing the A-D has not confirmed the October 17 record high in the actual Average. The non-confirmation may be blamed mostly on General Foods, but I don't like apologizing for technical discrepancies. So this is a place to watch and watch carefully.

A second area to watch is the lagging D-J Utility Average as seen on the page 1 chart. The Utility Average tends to be somewhat of a bellwether for the rest of the market, and the lag in Utilities is now blatantly obvious.

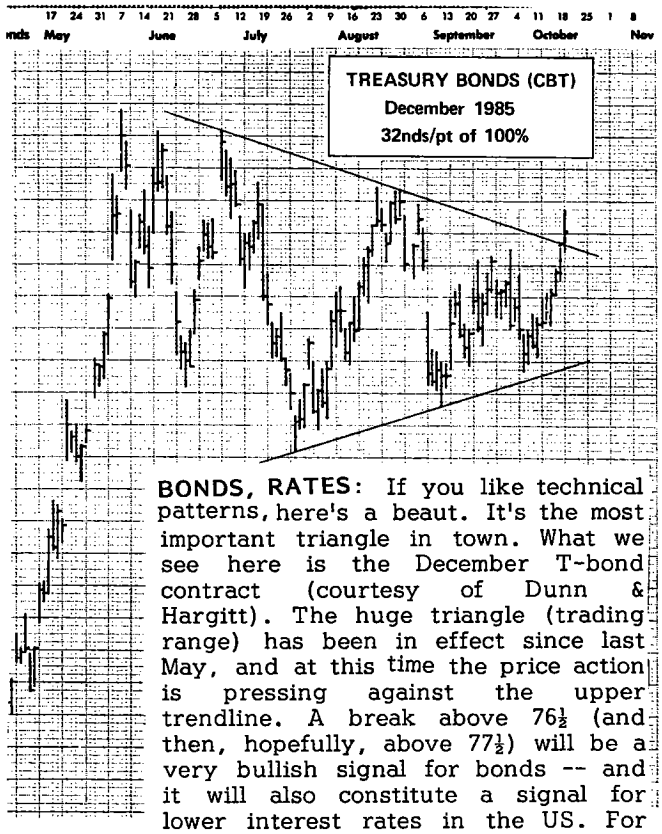


A third item I'm watching is the persistent lag in the secondary stocks (as measured by the broad Value Line Composite) in relation to the higher capitalization stocks (as measured by the S&P 500 Composite). This chart shows the ratio of the Value Line to the S&P 500. The picture is striking. Since June 1983 the Value Line has lagged the S&P 500. Those who own the smaller and more speculative stocks have no doubt sensed or felt this phenomenon. But I wonder how long the "poorer" section of the market can



underperform without bringing on trouble both in the economy and the stock market.

Finally, turning to the Value Line again, this chart (courtesy of Chartcraft, Larchmont, NY) presents a point & figure view of the Value Line Composite, and what I see here might be considered cause for thought (or worry). Again, a large potential head-and-shoulders pattern has formed. If, for the sake of argument, the Value Line were to turn down from here and crack support at 187, I would say "Duck, it's going to rain on Wall Street." The Value Line is a very broad composite of roughly 1700 stocks on the NYSE, AMEX and OTC. It represents a good cross-section of the kind of stocks that the average investor is likely to hold.



BONDS, RATES: If you like technical patterns, here's a beaut. It's the most important triangle in town. What we see here is the December T-bond contract (courtesy of Dunn & Hargitt). The huge triangle (trading range) has been in effect since last May, and at this time the price action is pressing against the upper trendline. A break above 76½ (and then, hopefully, above 77½) will be a very bullish signal for bonds -- and it will also constitute a signal for lower interest rates in the US. For the bears -- watch 74 on the December contract. If the contract hits 74, there's going to be trouble. My opinion: the pattern suggests that the breakout will favor the bulls.

INVESTMENT POSITION: Despite the things that I don't like about this market, I'll stick to the time-honored position that the trend (in this case, the bull trend) remains in force until proved otherwise. We see the head-and-shoulders pattern in the PTI, and this is a caution sign. We

see the lagging A-D ratio, the lagging Value Line and S&P 500 Composites, the lagging Transport and Utility Averages. But before I turn definitely bearish I would want (1) the PTI to break BELOW its 89-day MA, and (2) a Dow Theory bear signal, which at this point would require the D-J Industrials to close below 1297.94 and the Transports to close below 640.57.

I've put a rather smallish, nervous (sissy) bull in the box. He replaces the bigger, tougher bull. But he's still a bull.

For many months I have been recommending only the strongest Dow stocks rather than any secondary stocks and this policy has served us well. However, I continue to like the long-term outlook for the water utility stocks and my choices here are Southwest Water Co (OTC), American Water Works (NYSE), Consumers Water (OTC), SJW Corp (AMEX), Calif. Water Service (OTC). Despite warnings from many other advisory services, I continue to hold my municipal bonds. The yield on the top-rated tax-free munis is now 89% of the yield on Treasury bonds of comparable maturities. The munis continue to be too much of a bargain for me to resist.

WORLD REFLATION: This piece appeared on the front page of the October 9 LA Times. It's all part of the same package, and that package is called world reflation or "pumping up the globe". In his October 7 report, Jim Grant (Grant's Interest Rate Observer, 233 B'way, NYC 10279) takes the matter even further. In a brilliant piece entitled, "Why Volcker will quit," Jim presents his views, and I include those views here (Note: since this piece was written Volcker has denied that he will quit. So maybe we should retitle the piece, "It's rough for Paul Volcker, but nobody's going to push him around.").

WASHINGTON—The U.S. decision to move forward with a plan to ease the developing world's massive and worsening debt crisis is a major policy reversal by the Reagan Administration but may offer too little too late, international finance experts said Tuesday.

The proposal, unveiled in Seoul, South Korea, in weekend briefings by U.S. officials attending the annual International Monetary Fund meeting, was presented formally Tuesday in a speech by Treasury Secretary James A. Baker III.

The plan calls for a joint effort by the World Bank and the IMF, by the major commercial banks that Third World debt affects most heavily and by the borrowing countries themselves.

The debtor nations would have to commit themselves to open their markets to trade and investment, cut taxes and promote private sector growth. The World Bank and the IMF, meanwhile, would commit $9 billion and commercial banks $20 billion in loans over the next three years.

"...some further orderly appreciation of the main non-dollar currencies against the dollar is desirable...." —Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom and the United States, September 22.

If a conspiracy has been hatched to reflate the world economy, it is the noisiest cabal in history. Governments used to inflate on the quiet, like thieves cloaking their loot. Now they issue press releases.

Of course, there may be no reflation. It is by no means clear that Paul Volcker is "on board" the dollar devaluation program. The evidence suggests he is not. What is increasingly clear is that the Treasury Department means reflationary business and that a rift is widening between the administration and the Fed. The World Bank's balance sheet will shortly be mobilized to support more lending by commercial banks to insolvent governments (page two). The dollar, it is promised, will be devalued. Credit risk increasingly will be shifted to the public sector from the private.

The credit issue is out in the open. There are proposals to establish a "warehouse agency" to acquire the bad loans of the Farm Credit Administration: It's called the "Aggie Mae" plan. Not to be left out, the Independent Bankers Association of America, lobbyist for small banks, including hard-pressed farm lenders, has demanded a helping hand for private farm debt. And the other day, the Federal Home Loan Bank Board proposed another warehouse scheme to relieve the struggling Federal Savings & Loan Insurance Corp. of *its* bad assets (some $2.5 billion's worth).

More reflationary straws are in the wind. The Hunts of Texas have capitulated on silver: Long live silver. From Vienna comes dissension in OPEC and bearishness by the sheikhs on oil prices: In New York, meanwhile, the crude-oil contract for November delivery has pushed above $29. In Washington, the humiliation of the monetarists is complete. Nobody listens to them, and almost nobody watches M-1.

Before the so-called G-5 devaluation annoucement, not many people had expected a general reflation or even thought that such a policy was

technically possible. After all, in order to bring it off, the government would have to subdue the bond market. Furthermore, the government would have to enlist the cooperation of the chairman of the Federal Reserve Board, the man who, with infinite sangfroid, actually sold securities in the teeth of the run on Continental Illinois last year. Paul Adolph Volcker has come to occupy a unique monetary role. He is a monetary standard, personally. Floating exchange rates and unsecured paper money are gossamer things, but the person of the chairman has come to symbolize stability. Once there was gold, and now there is cigar ash.

At 2:29 Wednesday afternoon, the tape carried an official denial of yet another rumor that Volcker was quitting. There have been many such stories. The pattern of rumor and denial, in fact, as a friend points out, is not unlike the ritual lying that precedes a currency devaluation. The analogy is exact. Nowadays, Volcker himself is a kind of currency.

There is every reason for Volcker, whose term expires in 1987, to quit now. A fortune awaits him on Wall Street. His ego, which is proportionate to his six-foot, seven-inch height, was surely bruised by the G-5 affair. By the looks of the Fed balance sheet, which has not expanded, he is in no hurry to carry the administration's water. His sense of his place in history is wrapped up in the death of the 1970s inflation. He would be a poor candidate to preside over a 1980s reflation: If anyone on the Board of Governors of the Fed is up to the job, he is Preston Martin.

Volcker must sense that, in the marketplace of his reputation, the top tick is behind him. Things are so good that they can only get worse; the inflation is over and the deflation is only beginning. Why not get out when the getting's good? The bond market will miss him.

The new so-called G-5 program, which is in effect a devaluation of the dollar, is also part and parcel of the world reflation program. G-5 involves the US and four major partners in a synchronized effort to knock the dollar down to lower levels, thus (hopefully) improving the US balance-of-trade. Of course, with so many major US corporations now doing their manufacturing overseas, it is debatable whether a lower dollar will really help the US BOP.

But the great reflation experiment is on, no doubt about it. The fact is that the world is drowning in debt (all but Japan), and it's not only drowning in debt, it's drowning in lousy debt (i.e., debt that will never be repaid). So the idea is to keep the sagging balloon afloat with new credit and new international agreements. In other words, massive credits are needed to keep the banks afloat, the developing nations afloat, the major corporations afloat, the world afloat.

How do we as investors (and survivors) deal with world reflation? I wish I had the exact answer, but I don't. The inexact answers I have are these: (1) stay out of debt. In other words don't do what everybody else is doing -- which is going into debt. (2) Invest in only top-rated credit vehicles, and this includes stocks and bonds. If it isn't A-rated, leave it alone. (3) Diversify. Nobody on the face of this earth knows how the reflation attempt is going to affect securities. So the way to go is to diversify into high-grade vehicles, and this includes bonds, bills, stocks, some gold, a home and T-bills.

Yes, the great reflation experiment is on, but at this point we cannot tell whether it is going to be successful -- or if successful, we don't know how long it will continue to be successful. If reflation is successful, stocks "should be" a major beneficiary. Bonds will have to be "sanitized" or "held up" or somehow a floor will have to be put under bonds. How this will occur I don't know, but the obvious way is to manipulate interest rates DOWN. In fact, I would say that the TEST of the world reflation attempt will be the direction of interest rates. If interest rates push toward the old 1982 highs, all bets are off. The forces of reflation will have lost the game.

"How about the foreign currencies?" I am asked. "If the dollar is headed down, aren't the yen and the Swiss franc the obvious place to be?" And the answer is -- maybe, but this is a tough play for the average American. But yes, placing money in yen or buying a few yen and Swiss franc contracts may be the right play. I'm not averse to it.

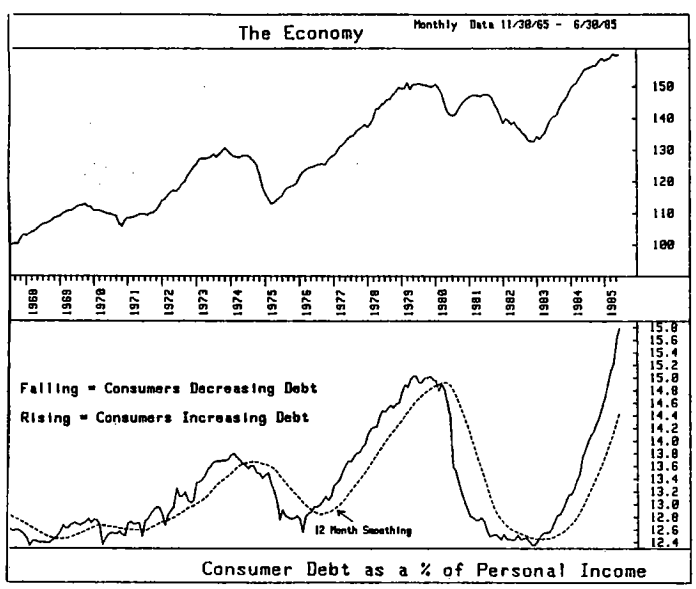
But for the average subscriber, I would advise staying with the dollar. Our big effort is to avoid losing money, rather than being brilliant about trading the currencies.

Right now the world of investing is one tough place to be. Gold and silver are sluggish and unresponsive. Bonds are in a trading range. Commodities may be a big play, but they are outside the ken of the average subscriber as are the currencies. Stocks should benefit from reflation, but if so, why is my PTI looking so toppy? And liquidity, dollars, how about that? I like dollars, and I do recommend a high percentage of liquidity here. After all it makes sense to be a maverick in the world of finance. And believe me, if you've got unmortgaged assets, dollars and no debt, you're a maverick. How many people do you know who have more assets than liabilities?

A friend was discussing the whole situation with me, and when we were through he expressed huge doubts about the dollar. "Listen," I replied, "all I can say is that lousy dollars are a damn site better than no dollars."

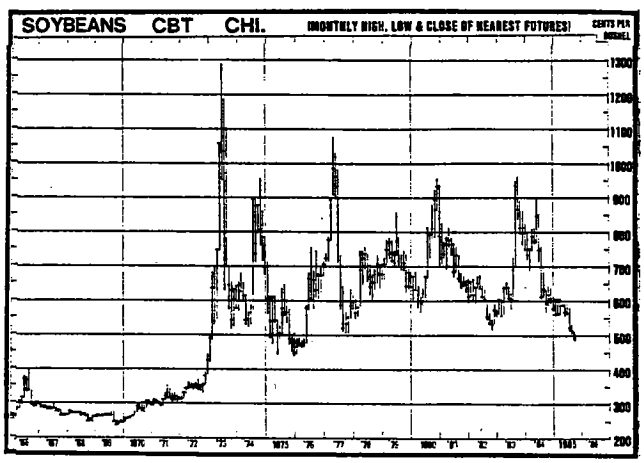
DEBT: As subscribers must know by now, I am not a lover of debt. A little debt may be OK, but little debts somehow always lead to bigger debts and finally to monstrous debts. The psychology of debt is like the psychology of dope. "Yeah, sure, I can handle it. I've got it under control, so don't worry about me, baby." Ironically, words like that identify the dope addict, a person who never is willing or able to admit that he is in the clutches of the chemical.

Frankly, I've always felt the same way about debt. I dislike it, I dislike the philosophy of debt, and I dislike where debts take people and nations. My father (he died in 1956) was in real estate all his life. One day he sat me down and said, "You know Dick, almost every builder I ever knew eventually went broke. They are all-fired enthusiastic at the top of a boom. They borrow, they build, and when the market goes to hell they go bankrupt. But there's one good thing about a building boom. The buildings get built! And after the builders are broke and forgotten, those buildings are still standing. Somebody else owns them -- but they got built. You have to hand that much to a boom."



This chart is from Ned Davis's Business Timing Guide. It shows what has been happening to consumer debt during the last few years. Here we see consumer debt has risen to almost 16% of personal income, the highest level ever. What has happened, I guess, is that the consumer thought the economy will be good forever, so why not live it up now and pay later. So the consumer is over his head in debt, and now we're nearing pay-off time. The only question is this: is the pay-off period going to be long and tedious or is it going to be quick and painful? I don't know the answer to that one -- nor does anyone else. But we do know one thing. Those lines of Ned Davis's chart are going to head down. It's pay-off time for John and Janey Doe.

NOTES & QUOTES: Farming: It's ironic but with half the world's population at the subsistence and even starving level, food surpluses the world over are building and building. In fact, with China and India now producing surpluses the problem is -- where to store it all? In the face of the bulging overages, commodity prices are listless or still dropping. The CRB Futures Index of 27 commodities, after hitting a seven-year low of 217, rallied to a weak 224 and is now back in the 222 area. On October 16, the soybean contract broke below the $5 market, sinking to the lowest price in 10 years (and the beans are our second biggest crop behind corn). This soybean chart (monthly) (courtesy of Commodity Research Bureau) shows the disaster on the farms vividly. On an inflation-adjusted basis, soybeans are back in the Great Depression.



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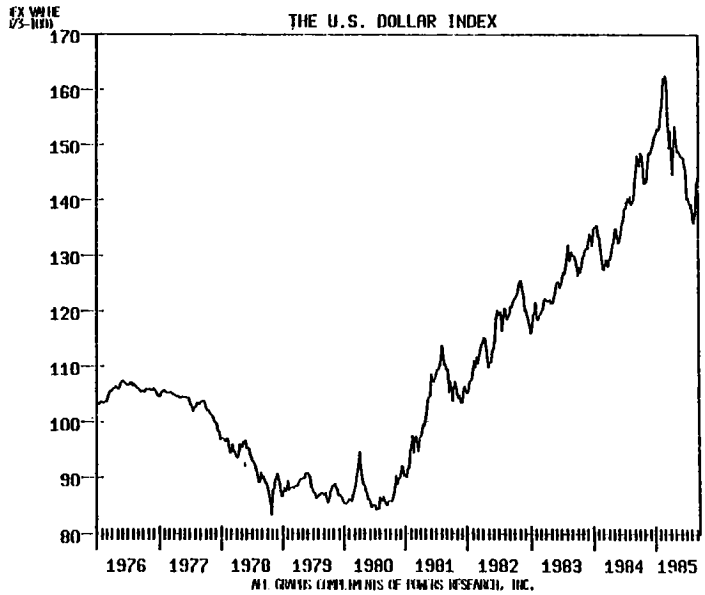
Many subscribers have called or written to ask me how to play against the dollar. Well, first let me tell you that playing against the dollar is dangerous because you're speculating in harmony with what everybody "knows". Sure, it's a lead-pipe cinch: The dollar is going to hell, and you can make a fortune speculating against it. As smart boys put it, "Tell me about it."

But if you're convinced that the dollar is going down the drain (and I'm not) then there's a new contract coming up on the Cotton Exchange that I think will be a winner. It's called the US Dollar Index, and it's an index composed of 10 foreign currencies with the greatest weights being given to the German mark and the Japanese yen. I like this contract as a play against the dollar better than I like gold or any single currency. Ask your broker about it if you want more information. If he doesn't know about it, ask him to get out of his swivel chair and find out. The accompanying chart shows the new Index taken back



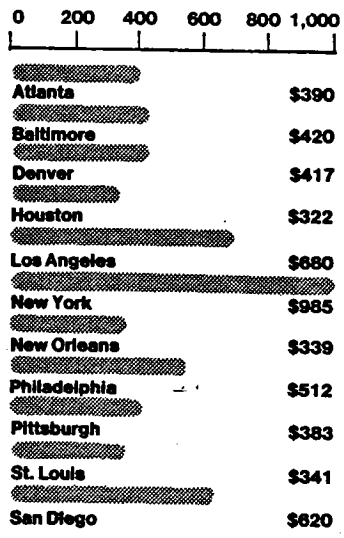
retroactively. Looking at the chart would you bet the house that the dollar has topped out? I don't think I'm quite ready to.

* *

Buy, Rent? Some top market advisors such as Barton Biggs (Morgan Stanley) believe the great housing boom is over and that a bear market in housing is now on. But a number of advisors disagree; they see more inflation ahead. I'm in the middle -- I just don't know. I still have my house, and I guess I'm positioned for deflation, because I own the house free and clear.

From a strict valuation standpoint, it hasn't paid to own a house in years. You buy a house for $200,000. That means you have tied up your money (or your mortgage loan) at say 12%. That's $24,000 a year or $2,000 a month. Then you try to rent that $200,000 house, and you find you can get only $600 a month for it. Which means that it's costing you the difference (forgetting the tax benefits) of $1,400 a month for the privilege of owning your own house.

These are typical 1985 monthly rentals for an unfurnished two-bedroom apartment, with one or one and a half baths in better neighborhoods. Rents exclude all utilities except water.



Source: American Chamber of Commerce Researchers Association

And that was OK when inflation was in the saddle and home prices were going up monthly. Today, it's a different story, because inflation is no longer a sure thing. And if Barton Biggs is right, it'll be costing you monthly income to hold a depreciating asset.

How about renting? Today (as per the example above), renting is an economic bargain. But again, there's a catch. It depends where you live. This chart shows you the wide differences in the cost of

rent in different parts of the US. LA, NYC and San Diego are expensive. Houston, New Orleans, St. Louis and Pittsburgh are bargains. The other day I was talking to some tourists who were here from Pittsburgh. I told them that Pittsburgh calls itself "America's most livable city". They laughed in my face, and told me to stay in San Diego. So everything is a matter of taste and choice.

* *

In the current (Oct. 28) issue of Forbes, there's a piece on the "hottest spot" in the US. It's none other than Santa Fe, N.M. Coincidentally, we took a two-day vacation to Albuquerque and Santa Fe last weekend. We went there just to take a look. I liked it -- but (naturally) not nearly as much as I like La Jolla.

But talk about Big Country, New Mexico is the sixth largest state (in area) in the nation with a tiny total population of 1.3 million. That's one person for every 6 acres! Albuquerque is in the magnificent high country, up at 5,000 feet. One gets a feeling of space in Albuquerque, space and blue sky, plains and mountains as far as the eye can see (which is at least 50 miles). New Mexico also has fabulous flying weather (360 days of sun a year). I might add that the airport at Albuquerque has the most mind-blowing collection of model airplanes I've ever seen -- maybe 1,000 in display case after case.

The little town of Santa Fe is at 7,000 feet, and I had real trouble breathing up there. Lots of Indians, Mexican-Indian food, silver, turquoise, and many tourists (we saw Goldie Hawn sitting in the front window of a little local cafe sipping coffee with a friend). We took a long horseback trip into the mountains, up to about 8,000 feet (I had even more trouble breathing there). But the landscape was magnificent. New Mexico gives you the feeling that it could contain the entire US population and still look unpopulated. I mean, this is big country and it's awe-inspiring. And yeah, the builders and land speculators are running wild in Santa Fe -- so see it before it disappears behind a blizzard of dollars.

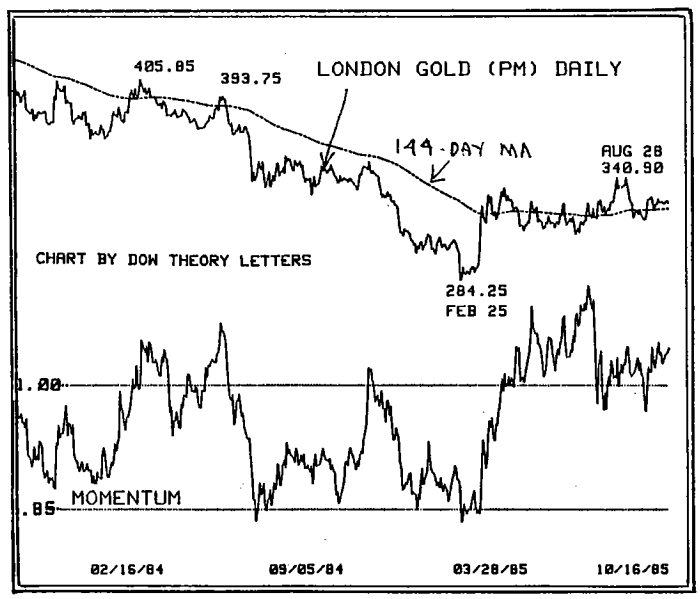
* *

The latest issue of Fortune magazine contains an article on why businessmen believe the Reagan Administration "blew it". Count me in agreement; I've been saying for months that the Administration has been chasing the wrong priorities in the wrong directions. Reagan blew it on the budget reduction, and he blew it on his "nobody cares" complicated tax-reform bill. Unfortunately, the constant threat of tax reform keeps businessmen and citizens confused as to how to operate. As far as deficit reduction, Reagan has waffled so much in this area that I personally can't figure out what he thinks.

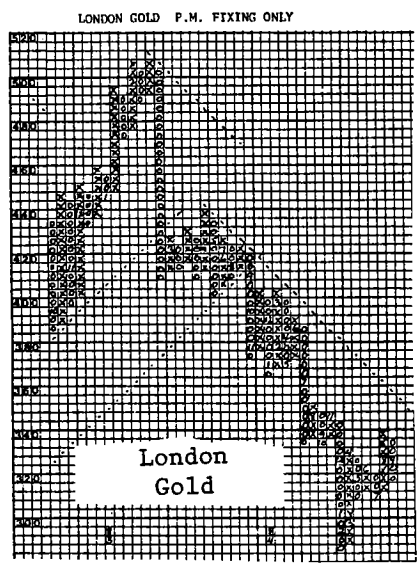
GOLD: Gold bulls don't die, they just wither away from boredom. But it won't always be that way, as those of us who held gold and gold shares during the late-1970s know. My computer-drawn chart shows the path of London gold along with the 144-day moving average. As you can see, gold is still holding above the moving average. And the MA is slowly, very slowly, rising. That's positive No. 1.

On the lower part of the chart we see "momentum", which is really an 89-day rate of change. As long as the momentum line holds above 1.00 (which it is now doing) it means that gold is above its price of 89 days ago. That's positive No. 2. So despite the boring look of gold at this writing, the metal is in the bullish mode. I continue to buy some gold coins each month, and to make it more interesting, I mix them up, buying Maple Leafs one month, Krugerrands the next and Chinese Pandas the third. The coins are all beautiful, and if gold never takes off I can just sit in my silly gold pile and pretend I'm a latter-day King Midas.

Oh yes, you'd like to know what would make gold look interesting. Easy, a rise above the August 28 peak of 340.90.



On this point & figure chart (chart courtesy of Chartcraft), it is clear that a rise to 344 would be a first bullish signal and a further rise to 364 would reverse the long descending trendline in gold -- and thereby turn the metal decisively bullish.



Then there's silver. Everyone was waiting for the Hunts to dispose of their silver -- after which the market was supposed to fly. Well, the Hunts have sold their silver; they've taken a billion dollar loss -- and what? Still no big silver action. Meanwhile, an ounce of silver is selling for less than a fiftieth of the price of an ounce of gold. Silver is cheap on an historical basis. But I still prefer gold.

LATE NOTES: Bonds (see page 3 chart) have broken out on the upside! Why? I could be dead wrong, but I don't think Congress would dare raise the debt ceiling to over $2 trillion without some kind of a deficit reduction rider. And the bond market would love that. ... The PTI was 1915 on Oct. 18, still 21 points below its Aug. 19 high. The A-D ratio (page 2 chart) hardly budged up on the new record Dow high. The same goes for the Transports. The warnings are there, but that's all they are so far -- warnings, not bear signals. **NEXT MAILING: November 6**